STATERA
ASSET MANAGEMENT

Commentary: May 2019

DON'T FORGET TO SAVE

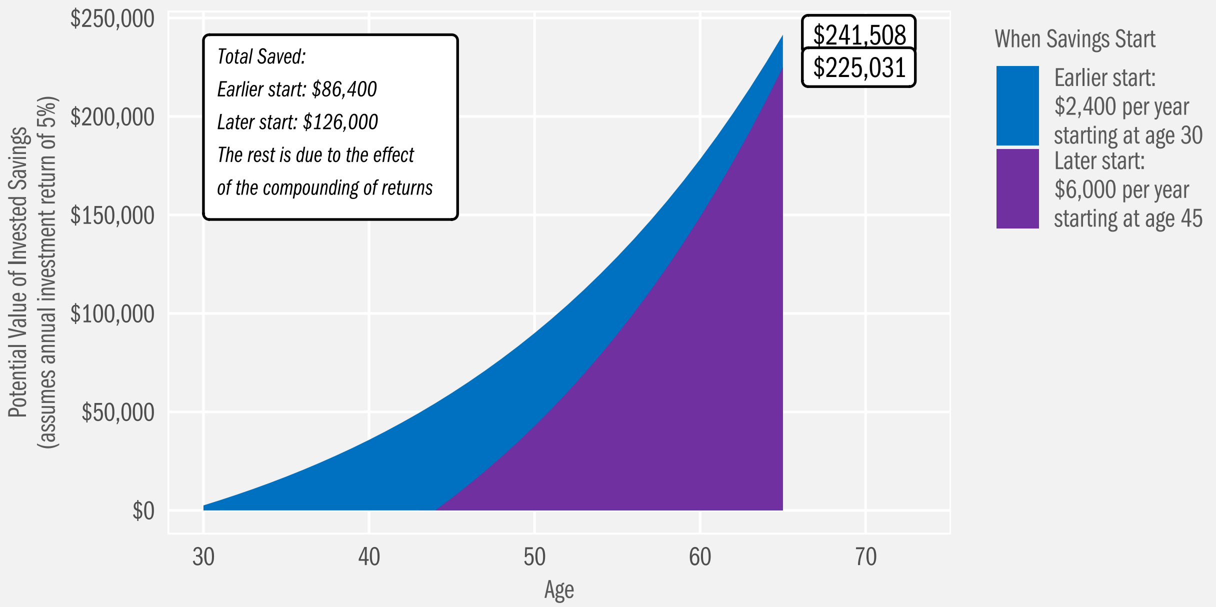
Our industry spends a great deal of time thinking about where a portfolio is invested and how those investments perform over time. Perhaps not enough time is spent discussing the force we think most impactful with regard to meeting long-term financial goals: savings. After all, without savings, there's no portfolio. And no manner of fanciful investment scenario can save a financial plan that focuses too little on dollars put away for far-in-the-future spending.

Sock it Away

There is much to be said for focusing on the factors under our control when it comes to investing. Perhaps those most under our control are the magnitude and regularity of our savings. Savings, of course, form the basis for any financial plan. While it may sound trite to suggest one should save as much as one can, it's the truth, nonetheless. Also important, demonstrated in Figure 1, is the potential benefit of starting a savings practice earlier in life. The first of two hypothetical reviews in this month's commentary, here we demonstrate the power of compounding. By compounding we mean the idea that each dollar invested in prior periods in theory can become more than a dollar through income and capital gain generated through investing. Further…the compounding bit…those gains, too, can add to more potential gains down the road.

Figure 1: Hypothetical Long-Term Savings and Investment Scenarios

An earlier start to saving may result in a larger pool of assets for use later in life



Scenarios are illustrative only and do not represent investment results, actual or otherwise. Value are not adjusted for inflation. Past performance is not indicative of future results. Investing in securities involves risk, including risk of losing some or all the invested capital. There is no guarantee that any investment or investment strategy will achieve its objective. SOURCE: SRCM

In a simpler example, $100 saved at the beginning of one year might become $105 at the end of the year, assuming a 5% return on the investment. Assume the same return the next year on those dollars, though, and one might end up with $110.25, as both the original $100 and the $5 that came from the first year's investment return gained 5% the second year. We may add to that an additional $100 saved that year and the return on those savings. With time, those original dollars can serve as the source of substantial longer-term gains. In the Figure 1 example, we assume a 30-year-old saver is putting away about a cable bill's-worth of money at the end of each year. By retirement, assuming a purely hypothetical (but not altogether unreasonable) 5% annual return, the individual might have generated more than $240,000 in savings. However, if the person might have waited 15 more years to begin investing, at age 45, even the maximum amount of $6,000 per year now allowable for those under 50 to invest in a personal individual retirement account (IRA) would not see those savings reach the same value as the earlier-saver's example. This, despite the former having been required to save much less overall.

Time, But Regularly

Even more, regular savings may provide an additional benefit toward reaching longer-term financial goals. To the extent we are saving and investing more often—monthly for example, rather than only annually—we may give ourselves greater opportunity to take advantage of any near-term volatility in the market. Indeed, for those folks who otherwise believe they'd like to be timing the market, we think the most defensible way to do so is through the regular investment of future savings. That is, we think folks should remain invested 100% at any given moment, but at a level of market exposure appropriate to their individual tolerance for market risk. And that means, perhaps, mixing generally risker stocks with generally less-risky bonds.

One then can use subsequent savings to rebalance the portfolio back to the target exposures defined by that tolerance for market risk. When equity markets are down, then, subsequent savings likely would be used to top-up that side of the portfolio. And when stocks have been on a run, subsequent savings may be used to invest in the less-risky side of the portfolio, perhaps helping to balance overall portfolio risk. Indeed, even for folks 100% invested in equities, subsequent savings still may be used to rebalance the portfolio into those market exposures that have trailed within the portfolio.

Setting Up Later Spending

Figure 1 exemplifies two important aspects of savings and investment. First, all else equal, a longer period of savings may result in larger ultimate value of those savings. That larger value may come from the fact that there's more time to save in absolute terms (e.g., adding up more $200 per month), and from the idea that invested savings have the potential to compound over time (i.e., subsequent investment gains may be found both on dollars saved and prior returns on earlier dollars saved). Ways to improve the end values include higher levels of savings and higher achieved investment returns. The former being rather more concrete in terms of its ability to bolster long-term values of invested assets, we tend to focus efforts there. Market returns for the most part will be what they will be. Our efforts on the investing side, then, tend to focus on ways to help clients maintain comfort with their investments through time, even when nearer-term market moves might not be so comfortable.

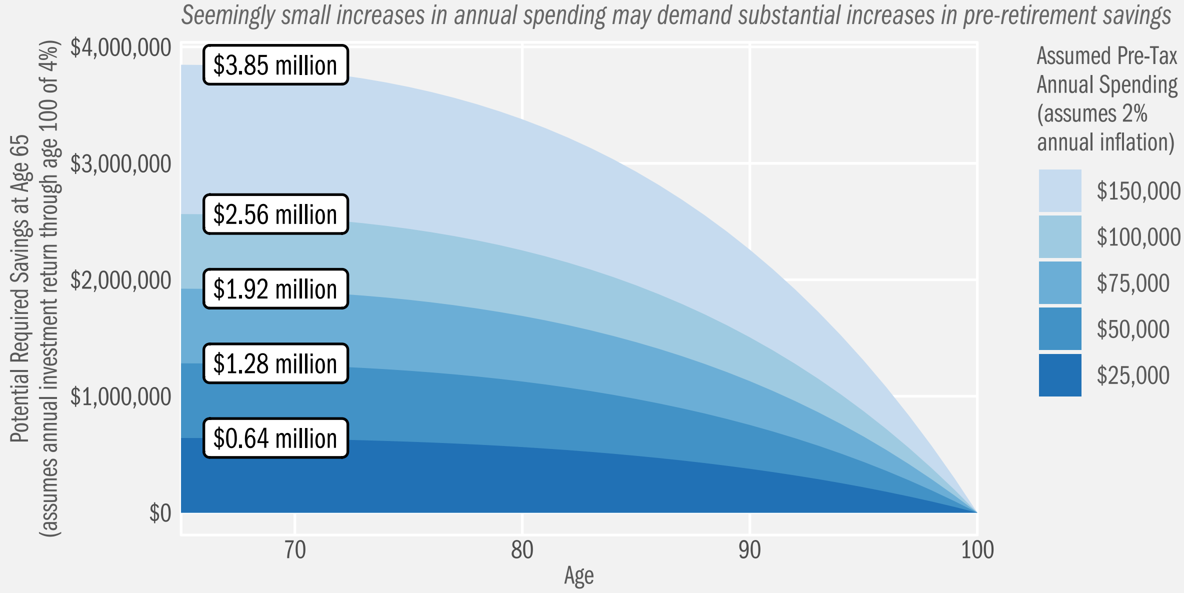
For many, again, the goal of savings earlier in life is spending later in life. Particularly when the question comes to retirement, we think folks should be thinking well in advance of their post-work years about what levels of savings would prove sufficient for an expected level of spending. In Figure 2, we present some scenarios to establish a way of thinking about drawing down savings later in life and to offer a sense of the magnitude of savings that may be required by folks in retirement.

To create the scenarios, we assume a retirement age of 65 and a life-in-retirement of 35 years. Assuming perfect timing—savings run out at the end of the 100th year—we then work backwards to see how much money one would have to have saved before retirement in order to support a specific level of annual pre-tax spending. The scenarios allow for an annual return on monies invested of 4%, while also assuming that spending rises by 2% each year to account for possible inflation.

Like we did on the savings side, we offer these data as a manner of perspective and to provide a sense of the levers that exist to alter retirement spending scenarios. At the minimum, five primary factors influence the longevity of our savings during retirement: 1) initial savings, 2) periodic spending (e.g., monthly, annual total dollars spent), 3) rate of inflation (to capture change in levels of spending that one cannot control), 4) expected rate of return on remaining investments and 5) expected longevity (how long might we live?).

Figure 2: Hypothetical Long-Term Retirement Spending Scenarios

Seemingly small increases in annual spending may demand substantial increases in pre-retirement savings



Scenarios are illustrative only and do not represent investment results, actual or otherwise. Scenarios assume each year's spending, which is increased at an inflation rate of 2% each year, is divested into cash at the beginning of the year with no assumed return for the year. Remaining assets otherwise are assumed to increase at a rate of 4% per year. Each scenario is designed to establish an initial level of savings at age 65 for each assumed level of spending that would reduce those savings to $0 at age 100, after an assumed annual total return from investments. Past performance is not indicative of future results. Investing in securities involves risk, including risk of losing some or all the invested capital. There is no guarantee that any investment or investment strategy will achieve its objective. SOURCE: SRCM

Put some estimates to those variables and we can develop a sense of the magnitude of savings required to support a given level of spending. For example, to support 35 years of $25,000 in annual income one would have had to have saved by age 65 more than $640,000 if one assumes those savings will continue to generate 4% per year in gains over time, while expenses continue to grow at 2% per year.

Impossible to See, the Future Is

Of course, none of those estimates is likely to turn out that way for anyone in particular. Expected annual returns may perhaps prove the most volatile over time, with significant implications for portfolio durability. Large market losses that may occur (perhaps are likely to occur, if history is any guide) during retirement would alter the smooth path we portrayed in Figure 2, perhaps breaking it altogether. Helps to remember, too, that while we may be able to manage exposure to market returns through the use of a range of asset classes (in our work, primarily equity and fixed income), we have much less influence with regard to market-relative returns (that is, whether we do better or worse than either the broader equity or fixed income markets). Rates of inflation will change over time as well, but likely in a manner less volatile than market returns. Levels of spending, too, will be volatile through the years. At least we have a bit more control over how much we spend. And try as we might, we are likely to have no idea when our time will come.

Keep Calm, Save On

With this commentary, we've attempted to express minimal foundations of a framework with which to plan for and live through retirement. In that sense, the scenarios we presented above are not meant to represent any that specifically might be appropriate for anyone reading this note. Rather, we offer them as a means to foster further discussion with regard to existing and potential savings, expected investment returns leading up to and during retirement, required and desired spending in retirement, and the path and plans that connect all of the above.

A range of diverse and generally rather complicated challenges may arise as we attempt to connect these two pieces of life's puzzle: how much to save and how much to spend. The goal of all the up-front and ongoing planning, of course, is to attempt to ensure that our monies don't expire before we do. The process of creating and revising the plan over time is perhaps the best approach to manage the uncertainty related to the assumptions we make about future investment returns and spending. Ultimately, it is with such discussions that we as advisors believe we may provide the most value to our clients.

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